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ASSET MANAGEMENT

Equity markets look ripe for a correction



Francis Sempill
Investment Manager
Walter Scott

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Walter Scott
Global Investment Management

While the recent rally in global markets has been a far more pleasant experience than what preceded it, the surge of the last six months looks and feels like a liquidity driven bear market rally. At the low point in March, lots of stocks around the world looked very cheap just when the rate of deterioration in many macroeconomic indicators began to abate. So conditions were in place for a bounce. Since then the rally has been fuelled by the massive amounts of liquidity created by policymakers, rather than any concrete evidence that the global economy has turned a corner.

Meanwhile, markets are discounting a large and rapid recovery in company profits, yet unemployment in major economies is still rising. This is bad news for demand and will translate into further bank write-offs. That's why we think that this is no time to suspend critical thinking.

A history lesson

We remain convinced that history holds a lesson for those investors who may have become swept away by the sheer exuberance of markets in the last six months or more. Between the market low point of 9th March 2009 and the end of September, the FTSE All World Index rose by 46.9%, which annualises to a 98.4% gain in sterling terms*. These are staggering figures and unsustainable

rates of return. We know from studying long-term market trends that very bad years for stocks are more often than not followed by vigorous rises, but more significantly that the majority of these peter out before a new bull market is established. For example, between 1929 and 1932 there were at least six false starts that led many people to believe that the bear market was finally over. In reality, it took until 1954 for the Dow Jones to return to pre-1929 crash levels.

However, before writing-off equities for the next 25 years, recall that for a period during the second quarter of the 20th century the US economy contracted by around 30%, while there was also the small matter of World War II. In any case, the Dow Jones at the end of September level of 9,712 is the same as it was over 10 years ago, so in actual fact we have already experienced a sustained period of no overall market gain.

While at Walter Scott we invest only in high quality growth companies, the severity of the economic downturn has meant that very few businesses around the world have been unaffected. Even the best companies have been reporting declining sales and profits. However, this provides opportunities for those companies robust enough to survive the bad times. Plenty of well known companies have entered the emergency room of Chapter 11 bankruptcy

*Source: Lipper as at 30 Sept 2009, in sterling terms

protection, while others have disappeared altogether. As far as we are concerned, it can undoubtedly be disruptive in the short term, when a competitor goes to the wall, but in the longer term it means more market share to play for.

Fundamental flaws

Furthermore, there may well be a nasty surprise for those investors hoping that the current rally will continue in the same vein. At Walter Scott, we spend most of our time studying corporate fundamentals, and it is becoming increasingly difficult to reconcile the earnings environment with share price performance over the last few months. Deleveraging is taking place everywhere we look, and companies and consumers alike are in 'balance sheet repair' mode.

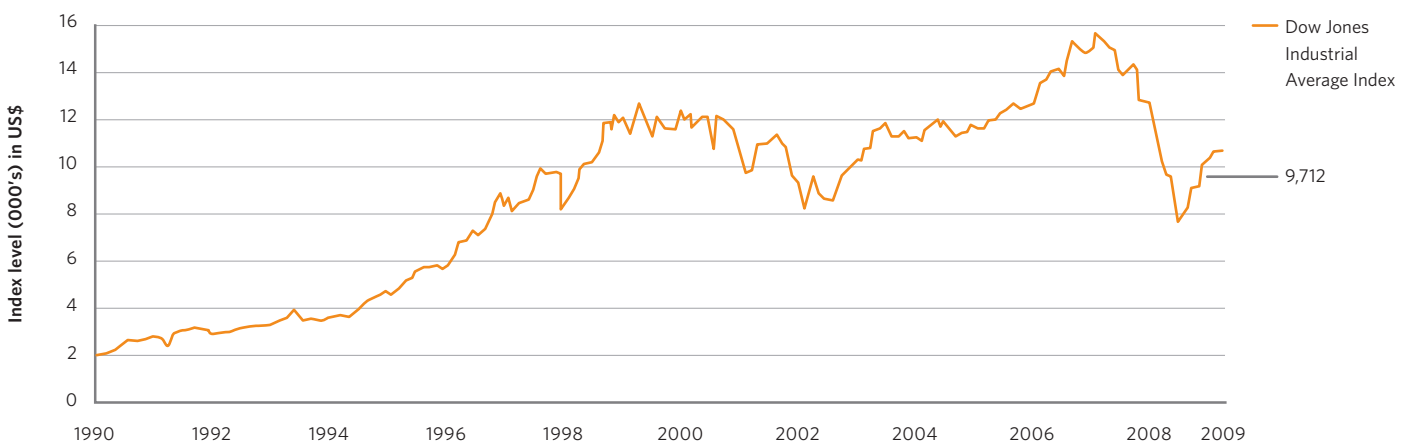
This removes money from the economic system - exactly what policy makers are trying to prevent.

Meanwhile, the loose monetary policy being pursued by authorities around the world is having little effect as far as real economies are concerned. Liquidity is flowing into financial assets and commodities, but it is not stimulating end-demand other than via highly specific measures such as the 'cash for clunkers' initiative to encourage motorists to trade in their older vehicles for newer models. We know from Japan's experience in the last decade how monetary policy can become ineffective, with it eventually being described as 'pushing on a piece of string'. Western economies are now

in very grave danger of imitating Japan's experience.

The debate rages about the outlook for growth, the prospects for inflation versus deflation and the direction of markets. Conjecture is easy but the bottom line is that no one knows with any degree of certainty what the future holds for the world's major economies and markets. One point on which Walter Scott holds an unwavering view is the requirement to stay fully invested in a select group of companies that meet the firm's return criteria. Over time, the power of compound growth and valuation-conscious stock picking will see portfolios through regardless of the background noise.

THE DOW JONES INDUSTRIAL AVERAGE INDEX UNCHANGED FROM 10 YEARS AGO



Source: Datastream as at 31 October 2009

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